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No. 81-2361

In the Supreme Court of the United States

OCTOBER TERM, 1981

STANLEY M. GROSSMAN,
PETITIONER,

v.

FIDELITY MUNICIPAL BOND FUND, INC. AND FIDELITY MANAGEMENT & RESEARCH CO.,
RESPONDENTS.

JOINT BRIEF OF RESPONDENTS IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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FIDELITY MUNICIPAL BOND FUND, INC. AND FIDELITY MANAGEMENT & RESEARCH CO.,
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JOINT BRIEF OF RESPONDENTS IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

The petition for certiorari invites this Court to interpret the opinion of the Court of Appeals to say what it did not say, to find conflict where none exists and to decide issues which need not be reached.

Opinions Below.

The opinion of the Court of Appeals is reported at 674 F.2d 115. The opinion of the district court is reported at 89 F.R.D. 656. Both opinions are reproduced in the appendix to the petition.

Statute and Rule Involved.

This action involves the relationship between Rule 23.1 of the Federal Rules of Civil Procedure and section 36(b) of the Investment Company Act of 1940, as amended, 15 U.S.C. § 80a-35(b). Both are reproduced in the appendix to the petition.

Statement of the Case.

This petition arises out of a mutual fund shareholder's derivative suit brought under the Investment Company Act of 1940, as amended, 15 U.S.C. §§ 80a-1, *et seq.* (the "Act").

Petitioner is a shareholder of Fidelity Municipal Bond Fund, Inc. (the "Fund"), a registered investment company. The defendants included Fidelity Management & Research Co. ("FMR"), which is the Fund's investment adviser, FMR's parent corporation and eight of the Fund's directors. The Fund was a nominal defendant. Only the Fund and FMR, however, have been named respondents in the petition for a writ of certiorari.

The complaint raised two claims, but only one is relevant now. That claim charges that the Fund paid FMR an exces-

sive management fee in violation of section 36(b) of the Act, 15 U.S.C. § 80a-35(b). Under the advisory and service contract between FMR and the Fund, FMR received a management fee computed at the annual rate of 0.4% of the Fund's average daily net assets. The complaint claimed that this fee was excessive in light of the allegedly substantial growth of the Fund's assets, routine investment decisions involved in managing the Fund and poor Fund performance.

The complaint also alleged excuse from the director demand requirement of Fed.R.Civ.P. 23.1, and prior to commencing suit petitioner made no demand upon the Fund's directors.

Defendants filed motions to dismiss the complaint under Rule 23.1. Following hearing on the motions, petitioner filed an amended complaint supplementing the Rule 23.1 allegations, and defendants again moved to dismiss. At the next hearing, the district court indicated readiness to rule on the motions. However, the court inquired whether petitioner would make demand and instructed the directors to consider such a demand if it were made. The next day petitioner sent a letter to the board of directors reciting verbatim the substantive allegations of the amended complaint and demanding action.

After receiving petitioner's letter, the board of directors appointed a special committee consisting of two statutorily disinterested directors who were not defendants. The board delegated to the special committee full powers to take action on behalf of the Fund with respect to the demand.

Following an investigation conducted by specially retained outside counsel,* the special committee determined that it was

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* Pursuant to authorization to retain independent advisers of their choice, the special committee retained a former chairman of the Securities and Exchange Commission as special outside counsel. Special counsel and his staff conducted a three-month investigation entailing document review, interviews and legal research. Upon completion of his investigation, special

in the best interests of the Fund that the action be dismissed and instructed the Fund's counsel to take appropriate steps to do so. The Fund, joined by the other defendants, then moved to dismiss or for summary judgment.

Following further hearing, the district court dismissed the action; in the alternative, the court granted summary judgment in favor of defendants. The district court based its decision, alternatively, upon petitioner's failure to make demand prior to commencing suit and upon the good faith business judgment determination of the special committee following the belated demand.

Petitioner then appealed. On March 29, 1982 the Court of Appeals for the First Circuit affirmed the district court, "on the former ground, by-passing the latter." 674 F.2d at 118. With respect to the excessive management fee claim, the Court of Appeals rejected a variety of arguments raised by petitioner in an effort to demonstrate that Rule 23.1 is wholly inapplicable to shareholder suits under section 36(b). *Id.* at 118-23. The Court of Appeals concluded that "there is no persuasive indication that, in adopting section 36(b), Congress wished to repeal or limit the demand provision of Rule 23.1 which has long been a general part of our federal law practice and procedure, governing almost all derivative actions in federal courts." *Id.* at 122.

Having found Rule 23.1 applicable to petitioner's suit, the Court of Appeals next concluded that demand was not excused.

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counsel submitted a 230-page report to the committee. The report set forth detailed factual findings, legal conclusions and recommendations for action. With respect to the excessive fee claim, special counsel concluded that the Fund's directors had been "fully informed" by FMR regarding facts necessary to their periodic decisions to approve the Fund's management fee; that they had "independently evaluated" all relevant information; and that they had engaged in "meaningful negotiations" with FMR. Special counsel also concluded that the fee had been "fair" and "not excessive." Special counsel advised the committee to seek to dismiss petitioner's suit.

Id. at 123-25. Finally, the Court of Appeals held that petitioner's post-litigation demand did not cure his failure to make demand before commencing suit and that therefore the action had been properly dismissed. *Id.* at 125-26.

The Court of Appeals concluded its opinion by emphasizing that it had refrained from considering whether defendants were entitled to judgment by virtue of the business judgment decision of the directors following petitioner's belated demand. *Id.* at 126.

Reasons for Denying the Writ.

A. The Decision of the Court of Appeals does Not Conflict with Decisions of This Court.

In asserting that the decision of the Court of Appeals conflicts with decisions of this Court, petitioner urges the Court to find conflict where there is none and to rule on issues which need not be decided.

1. *There is No Conflict With* Burks *v.* Lasker.

Petitioner argues that the decision of the Court of Appeals conflicts with an observation regarding directorial termination of suit made by this Court in *Burks* v. *Lasker*, 441 U.S. 471 (1979). (Petition pp. 7-8). But the asserted conflict is imaginary, and the issue is in any event inadequately presented here.

Burks involved judgment entered against a mutual fund shareholder in a derivative suit under section 13(a)(3) and former section 36 of the Act and under section 206 of the Investment Advisers Act. During pendency of the action, the

disinterested minority of fund directors had investigated the claims and concluded that further prosecution of suit was against the best interests of the fund. Based upon this determination, the fund successfully moved for summary judgment. 441 U.S. at 473-75. The question in *Burks* was whether the disinterested directors had the power to terminate the derivative suit in the exercise of their business judgment, 441 U.S. at 473, and this Court held that "federal courts should apply state law governing the authority of independent directors to discontinue derivative suits to the extent such law is consistent with the policies of the [Investment Company and Investment Advisers Acts]." *Id.* at 486.

During the course of considering the issue before it, the Court observed that:

> when Congress did intend to prevent board action from cutting off derivative suits, it said so expressly. Section 36(b), 84 Stat. 1428, 15 U.S.C. § 80a-35(b)(2), added to the Act in 1970, performs precisely this function for derivative suits charging breach of fiduciary duty with respect to adviser's fees.

Id. at 484.

Far from conflicting with *Burks*, the Court of Appeals expressly avoided deciding whether the Fund's disinterested directors could terminate petitioner's section 36(b) suit through the exercise of business judgment. The Court of Appeals declined to affirm the district court on this basis and bypassed decision on this ground. 674 F.2d at 118, 126. The court did so in an explicit effort to resolve the case on narrower grounds and to avoid any conflict with *Burks*. *Id.* at 121. Indeed, in reaching its decision, the Court of Appeals assumed "*arguendo*" that this Court's dictum in *Burks* precluded the

Fund's disinterested directors from terminating petitioner's section 36(b) suit. *Id.* Given the pains taken by the Court of Appeals to avoid decision on grounds which may be affected by *Burks*, there can be no conflict for this Court to resolve. *See* Sup. Ct. R. 17.1(c).

Burks itself, for that matter, did not involve application of Rule 23.1. The Court's opinion does not mention, let alone analyze, the demand requirements of Rule 23.1; indeed, the district court had previously indicated that the issue of demand under Rule 23.1 "is not presented in this case." *Lasker* v. *Burks*, 404 F.Supp. 1172, 1178 (S.D.N.Y. 1975). Nor did *Burks* even involve a claim under section 36(b). In its opinion this Court did not address the interplay of the statute and the rule and indicated no intention to provide guidance in applying them together. The focus in *Burks* was upon the power of directors to terminate a derivative suit already properly commenced. 441 U.S. at 486. Construction and application of Rule 23.1, which sets conditions precedent to derivative suit, are matters to which the Court did not speak.

Moreover, this Court is unlikely to reach the issue of asserted conflict should certiorari be granted. The Court of Appeals decided the case on narrow grounds. The court concluded that the demand requirement of Rule 23.1 serves substantial purposes unaffected by a limitation on the power of directors to terminate derivative claims. 674 F.2d at 121. Only if the grounds of the lower court's decision are insufficient would this Court need to address the grounds by-passed below. Yet the reasoning of the Court of Appeals was sound. Demand serves to exhaust intracorporate remedies prior to suit. *Galef* v. *Alexander*, 615 F.2d 51, 59 (2d Cir. 1980); *Lucking* v. *Delano*, 117 F.2d 159, 160 (6th Cir. 1941); 3B *Moore's Federal Practice*, ¶ 23.1.16[1] at 23.1-49 (2d ed. 1982). Negotiation, arbitration and unilateral directorial action are available to

redress mutual fund shareholder grievance. *See Markowitz* v. *Brody*, 90 F.R.D. 542, 560-61 (S.D.N.Y. 1981); *Weiss* v. *Temporary Investment Fund, Inc.*, 516 F.Supp. 665, 669-70 (D. Del. 1981); *cf. Boyko* v. *Reserve Fund, Inc.*, 68 F.R.D. 692 (S.D.N.Y. 1976). At the very least, as the Court of Appeals noted, directorial response to demand might be a matter of considerable significance to a district court when deciding the merits of a section 36(b) claim. In this regard it should be noted that the provisions of subparagraph (b)(2) require directorial approval to be given "such consideration by the court as is appropriate under all the circumstances." 674 F.2d at 121.

Finally, since the Court of Appeals avoided decision on the question of directorial termination of suit, it articulated no analysis of the relevant issues of law. Nor for that matter is there a body of law developed by other courts of appeals on the subject. *See Vasquez* v. *United States*, 50 U.S.L.W. 3343 (November 2, 1981). The Court of Appeals also declined analysis of the facts and circumstances of the case relevant to such an exercise of directorial power. The case is ill-suited, in short, for dispositive decision by this Court because the question was not thoroughly assayed below. *Cf. Maryland* v. *Baltimore Radio Show, Inc.*, 338 U.S. 912, 918 (1950) (opinion of Frankfurter, J.).

2. *There is No Conflict with This Court's Implied Right of Action Cases.*

Petitioner argues that certiorari should be granted because the decision of the Court of Appeals "implied a right of action in contravention of standards" enunciated by this Court. (Petition p. 9.) But this asserted conflict is similarly imaginary, and the issue is peripheral to the case.

In the course of its opinion, the Court of Appeals concluded that a mutual fund has a right of action under section 36(b). The court expressed this view in response to petitioner's argument that a mutual fund itself has no right of action under the statute and that, because it has none, Rule 23.1 does not apply. 674 F.2d at 120. Petitioner argues, in short, that a determined directorate cannot sue; only a shareholder can. But since Congress clearly contemplated a damage remedy for the benefit of the mutual fund, the argument makes no sense. In fact, the Court of Appeals discussed the point in a section of its opinion addressed to a series of petitioner's arguments which the court believed "to have little merit." *Id.* The court disposed of the argument by noting its disbelief that a "new and independent" board of directors would be "precluded from suing" under section 36(b); by concluding that, in providing for suit by a shareholder "on behalf of" an investment company, it was "unnecessary" for Congress to say "with particularity" that the company could bring suit itself; and by observing that in all other respects petitioner had proceeded on the "correct assumption that this is a derivative suit to enforce rights the Fund could itself enforce. . . ." *Id.*

The conclusion of the Court of Appeals does not conflict with this Court's recent implied right of action cases. There is no decision of this Court holding that an investment company may not sue under section 36(b); hence, there is no direct conflict to resolve. *See* Sup. Ct. R. 17.1(c).

Nor is there any conflict with the principles of statutory construction announced by this Court's recent decisions. The issue, of course, is one of Congressional intent. *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, 444 U.S. 11, 15-16 (1979). Background, language, purpose and legislative history bear on the question. Considering all, the Court of Appeals was clearly correct.

"In determining whether a private cause of action is implicit in a federal statutory scheme . . ., the initial focus must be on the state of the law at the time the legislation was enacted." *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Curran*, 50 U.S.L.W. 4457, 4464 (May 3, 1982). At the time of enactment of section 36(b), implied rights of action under the Act had been recognized by the federal courts, and they had been regarded as derivative claims. *See, e.g., Levitt* v. *Johnson*, 334 F.2d 815 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965); *Chabot* v. *Empire Trust Company*, 301 F.2d 458 (2d Cir. 1962); *Brown* v. *Bullock*, 294 F.2d 415 (2d Cir. 1961). During its passage through hearings, section 36(b) was supported by reference to these decisions and by discussion of the salutary effect of "derivative actions" under the federal securities laws. *See, e.g.*, Hearings before the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce on H.R. 11995, S.2224, H.R. 13754, and H.R. 14737, 91st Cong. 1st Sess. 202, 699, 796, 881. A derivative claim, of course, is a claim of the mutual fund. It must be enforceable, as well, by the fund itself.

The language of section 36(b) bears this out, as the Court of Appeals noted. 674 F.2d at 120. Under the terms of the statute, petitioner has sued "on behalf of" the Fund, for alleged breach of fiduciary duty with respect to compensation "paid by" the Fund, seeking damages limited to the amount of compensation "received from" the Fund. Here "the statutory language itself fairly implies a right" of action on the part of the Fund itself. *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, *supra*, 444 U.S. at 18.

The "structure of the statute," *id.*, likewise supports the Fund's right to sue. It is apparent that section 36(b) was "intended to benefit" the Fund, *id.* at 17, for the statute creates federal rights "in favor of" the Fund. *Touche Ross & Co.* v. *Redington*, 442 U.S. 560, 569 (1979). The Fund is "one of the

class for whose *especial* benefit the statute was enacted." *Cort* v. *Ash*, 422 U.S. 66, 78 (1975).

Petitioner's argument to the contrary, for that matter, derives not from decisions of this Court so much as from an unsupported assumption. Petitioner asserts that mutual fund directors cannot sue under section 36(b) "since the basic motivation for that provision was a recognition that the directors of a mutual fund could not be trusted to make an objective decision concerning fairness of compensation." (Petition p. 10; *id.* p. 8.) Nothing, however, could be wider from the mark. Under the overall scheme of the Act, disinterested directors serve as "watchdogs" of the mutual fund. *Burks* v. *Lasker*, *supra*, 441 U.S. at 484. The 1970 amendments to the Act, which added section 36(b), were designed to enhance, not deprecate, this role of the disinterested directorate. *See id.* at 482-84. As for section 36(b) itself, the Senate Committee reported: "This section is not intended to authorize a court to substitute its business judgment for that of the mutual fund's board of directors in the area of management fees." S. Rep. No. 91-184, 91st Cong. 2d Sess., *reprinted in* 1970 U.S. Code Cong. & Admin. News 4897, 4902. The committee admonished that "the section is not designed to ignore concepts developed by the courts as to the authority and responsibility of directors. . . . The section is not intended to shift the responsibility for managing an investment company in the best interests of its shareholders from the directors of such company to the judiciary." *Id.* at 4903.

Petitioner's argument is, in effect, that Congress intended that a federal court should be obliged to dismiss suit initiated by mutual fund directors if they found past fees to have been excessive and sought judicial relief themselves. In light of the central role of the disinterested directorate, this result is inconceivable.

Although petitioner cites *Boyko* v. *Reserve Fund, Inc.*, 68 F.R.D. 692, 695-96 (S.D.N.Y. 1975), and *Blatt* v. *Dean Witter Reynolds Intercapital, Inc.*, 528 F.Supp. 1152, 1155 (S.D. N.Y. 1982), to support his position, these decisions suffer the same flaw in fundamental premise as does petitioner's argument. Other district courts have directly disagreed. Within the Southern District of New York itself, for example, both *Boyko* and *Blatt* have been rejected for having "ignored the congressional imperative for independent management of money market funds and mistakenly presumed . . . that the directors of an investment company are uniformly antagonistic to 'an action against the Fund's advisors for breach of fiduciary duty with respect to the receipt of compensation.'" *Fox* v. *Reich & Tang, Inc.*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 98,612 at 93,023 (S.D.N.Y. April 2, 1982).

Finally, it is not at all clear that determination of a mutual fund's right to sue under section 36(b) is necessary to decision as to the applicability of Rule 23.1. The Court of Appeals reasoned that demand serves important purposes unrelated to any directorial decision regarding suit. A right might be enforced or a groundless claim abandoned without litigation, and, in any event, a record of directorial deliberation would be made. 674 F.2d at 121. Other courts have agreed. *See Gartenberg* v. *Merrill Lynch Asset Management, Inc.*, 91 F.R.D. 524, 526 (S.D.N.Y. 1981); *Markowitz* v. *Brody, supra*, 90 F.R.D. at 560-61.

Four district courts, other than the district court below, have held Rule 23.1 applicable to a section 36(b) suit. But decision has not necessarily turned on the fund's right of action. One court expressly ruled that a fund itself may sue. *Markowitz* v. *Brody, supra*, 90 F.R.D. at 557 n.12. One avoided the point by finding other purposes served. *Gartenberg* v. *Merrill Lynch Asset Management, Inc., supra*, 91 F.R.D. at 526. Two ruled without reaching the issue. *Fox* v. *Reich & Tang, Inc.*,

supra; *Weiss* v. *Temporary Investment Fund, Inc.*, *supra*. Two district courts, on the other hand, have found the demand rule inapplicable. *Boyko* v. *Reserve Fund, Inc.*, *supra*; *Blatt* v. *Dean Witter*, *supra*. Although both voiced the view that a mutual fund itself cannot sue under section 36(b), one curiously found demand under Rule 23.1 to be excused, for futility, only if there is an interested member on the board of directors. Otherwise the court's ruling was "not to be construed as a holding that Rule 23.1 has been in any way abrogated by Section 36(b)." *Boyko* v. *Reserve Fund, Inc.*, *supra*, 68 F.R.D. at 696.

If there is inconsistency among the district courts, the task of resolution belongs in the first instance to the courts of appeals. Perhaps then uniformity, or at least clarity of the issues, will emerge. Mr. Justice Frankfurter's observation is surely apt: "It may be desirable to have different aspects of an issue further illumined by the lower courts. Wise adjudication has its own time for ripening." *Maryland* v. *Baltimore Radio Show, Inc.*, *supra*, 338 U.S. at 918.

B. The Decision of the Court of Appeals does Not Conflict with the Decision of the Court of Appeals for the Third Circuit in *Lewis* v. *Curtis*.

Petitioner claims that the decision of the Court of Appeals conflicts with the decision of the Court of Appeals for the Third Circuit in *Lewis* v. *Curtis*, 671 F.2d 779 (3d Cir. 1982). But, on facts as on law, these decisions have little in common.

Lewis is a case growing out of a shareholder challenge to his corporation's settlement of a proxy contest. Plaintiff claimed that the settlement constituted a waste and spoliation of corporate assets. Prior to filing his complaint plaintiff made no demand on the corporation's directors, and afterward he sought

to amend in order to plead particulars showing excuse. The district court denied leave to amend and dismissed the complaint, but the Third Circuit reversed, holding the denial of leave to amend to be an abuse of the district court's discretion.

The issue for decision in *Lewis* was whether the amended complaint pleaded Rule 23.1 excuse with requisite particularity. *Id.* at 783-84. The Court of Appeals found that the amended complaint contained "detailed allegations concerning the financial interests" of the directors in the challenged transaction and showed that the transaction was part of a "larger scheme" by these directors to "retain control" of the corporation. *Id.* at 784. In the course of its analysis, the Court of Appeals reasoned that it should apply the same standard of "interestedness" in reviewing the demand requirement in the first instance as it would use in reviewing directorial rejection of demand later. *Id.* at 785-86. Given directorial financial interest in the challenged transaction, the court concluded that any decision in response to demand would be inconsistent with the directors' fiduciary duty to render business judgments free from bias. *Id.* at 786. Upon plaintiff's allegations, "the directors to be sued would control the response to any demand." *Id.* Due to their financial interest, therefore, demand on the directors was found to be futile. *Id.* at 786-87.

Simple summary of the case reveals that the court in *Lewis* decided different issues of law upon different circumstances of fact than were presented to the Court of Appeals below. The issue in *Lewis* was Rule 23.1 excuse; the issue here is Rule 23.1 applicability. The facts in *Lewis* involved financial self-interest; the facts here reveal a disinterested directorate. In *Lewis* the Third Circuit concluded that directorial interest made demand futile because no directorial action in response to demand could be free from bias; no directorial action, in short, could be proper. Here, on the other hand, under an interpretation of statute which the Court of Appeals assumed *arguendo*,

the range of directorial response to demand may be limited, but it is not wholly foreclosed. In *Lewis* the directors were defendants; hence they were disabled from taking any proper action. Here, by contrast, the directors stood ready to act and had options available. Under these circumstances there can be no square and irreconcilable conflict to justify review. *See, e.g., Bailey* v. *Weinberger*, 419 U.S. 953 (1974) (dissenting opinion).

Indeed, the Court of Appeals below and the Third Circuit in *Lewis* do not even conflict in "approach," as petitioner asserts. (Petition p. 12.) Both courts in fact considered the scope of permissible directorial response to demand before determining whether derivative suit may be maintained in the absence of demand. The results were different, to be sure, but that was because in one case the directors could act, while in the other they could do nothing at all.

The decision below neither conflicts with *Lewis* nor decides the same question. There is nothing in either case to suggest that the Third Circuit would have reached a different result here than did the First.

Conclusion.

For the foregoing reasons the petition for a writ of certiorari should be denied.

Respectfully submitted,

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